

## **Social Security (FICA) and Medicare Taxes - FAQs**

*Employer and employee pension contributions paid to KRS are currently excluded when calculating required Social Security contributions. Why?*

The method that the Commonwealth and most government employers in Kentucky have used to calculate their Social Security and Medicare tax liability for each payroll is by deducting the employer and employee pension contributions from the employee's gross wages to arrive at taxable FICA wages.

*Why were Kentucky employers allowed to make this deduction?*

Beginning in 1983, Congress and Kentucky passed legislation under 414(h) of the United States Internal Revenue Code that removed pension contributions from the employee's gross income until pension benefits were distributed by the pension system. This legislation exempted these payments, if the employer through withholdings paid the retirement deductions directly to the retirement system. Additionally, Kentucky had a private letter ruling from the Internal Revenue Service (IRS) that allowed this deduction.

*I heard that Kentucky employers will no longer be able to deduct pension contributions from the calculation of Social Security and Medicare tax liability. Is that true and why?*

Yes. During the period between 1983 and late 1999, various appeals court cases and rulings have been made regarding FICA and Medicare tax treatment of pension contributions. In addition, the IRS has continued to phase out private letter rulings. Kentucky is the last state to be addressed. The IRS required that Kentucky prepare a reasonable plan to change the treatment of the pension contributions to bring the state in compliance for calculating FICA and Medicare contributions. The IRS and the Kentucky Finance and Administration Cabinet have reached a settlement of this issue.

*When will the change be effective?*

Both employees and employers will be impacted by this change beginning January 1, 2017. This settlement affects all governmental employees in the various retirement plans, including the executive, legislative, and judicial branches of state government, eight universities, the Kentucky Community and Technical College System, and 1,471 counties, city and local school districts. The state estimates that the additional annual cost will be approximately \$5.7 million for state government agencies alone.

*What is the impact of the change?*

Every affected employee will see a reduction in net income due to the additional tax withholdings. For all employees who participate in Social Security, the additional contributions will result in increased Social Security benefits upon retirement. For income tax purposes, the employee retirement withholdings continue to be exempt.